## COMMONWEALTH OF MASSACHUSETTS DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Investigation by the Department of Telecommunications and Energy on its own Motion into the Appropriate Pricing, based upon Total Element Long—Run Incremental Costs, for Unbundled Network Elements and Combinations of Unbundled Network Elements, and the Appropriate Avoided Cost Discount for Verizon New England, Inc. d/b/a Verizon Massachusetts' Resale Services in the Commonwealth of Massachusetts

D.T.E. 01-20

## SURREBUTTAL TESTIMONY of HARRY GILDEA

on behalf of

## THE UNITED STATES DEPARTMENT OF DEFENSE AND ALL OTHER FEDERAL EXECUTIVE AGENCIES

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## SURREBUTTAL TESTIMONY OF HARRY GILDEA

- 2 Q. What is your name and business address?
- 3 A. My name is Harry Gildea. My business address is 1220 L Street, N.W.,
- 4 Suite 410, Washington, D.C. 20005.
- 5 Q. Have you previously submitted testimony in this case?
- A. Yes. I submitted Rebuttal Testimony on behalf of the consumer interests of
- 7 the United States Department of Defense and All Other Federal Executive Agencies
- 8 (DOD/FEA) on July 16, 2001. That testimony contains a summary of my experience and
- 9 qualifications.

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- 10 Q. What are the principal conclusions and recommendations in your Rebuttal
- 11 Testimony?
- 12 A. I identified several infirmities in Verizon's studies of the costs of unbundled
- 13 network elements ("UNEs"). I urged the Department to address these issues because they
- 14 lead to inflated charges for UNEs.
- 15 Q. What is the purpose of your current testimony?
- A. I address rebuttal testimony by Verizon witnesses Timothy J. Tardiff and
- 17 James H. Vander Weide; AT&T/WorldCom witnesses Michael R. Baranowski, John C.
- 18 Donovan, and John I. Hirshleifer; and CLEC Coalition witnesses August H. Ankum and
- 19 Warren R. Fisher.
- 20 Q. What issues do you address in Verizon witness Tardiff's testimony?
- A. I disagree with witness Tardiff's assertion that the Hatfield model employed
- 22 by AT&T is "patently unreliable" and therefore should not be used in preference to
- 23 Verizon's cost studies in this case.1
- Q. Why do you dispute this claim?

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Rebuttal Testimony of Timothy J. Tardiff, pp. 12–44.

- A. Witness Tardiff's assertion that the Hatfield model develops unreasonably low costs does not reflect a balanced assessment of the possible reasons for differences between the Hatfield costs and the costs determined with Verizon's models. For example, witness Tardiff contrasts the investment of about \$3,000 per line by competitive LECs with the Hatfield model indication that the investment should be only about \$500 per line.<sup>2</sup> He asserts that this disparity results from infirmities in the Hatfield model. However, it is likely that the disparity reflects the very high costs for carriers to provide local exchange services in competition with the incumbent LEC.
  - Q. Why would the costs for competitive LECs be so high?
- A. Many factors lead to high costs for competitive LECs. These competitors must incur disproportionately large start—up costs, and suffer from huge diseconomies of scale. Moreover, competitors must build nearly all of their basic infrastructure from scratch. In contrast, the incumbent carrier's costs (which the Hatfield model is intended to replicate) reflect incremental build—outs on a network that has been in place serving millions of subscribers for many years. With these differences, I am not surprised at major cost differentials.
  - Q. What is the significance of the high costs that competitors incur?
- A. High costs for competitive LECs underline the need for the Department to ensure that UNE charges do not exceed the incumbent carrier's incremental costs. Since competitors must incur high costs to build their own facilities, they are initially dependent on the incumbent carriers' UNEs to provide services to their subscribers.
- Q. Does witness Tardiff cite examples where AT&T's approach yields much lower estimates of UNE costs than the approach employed by Verizon?
- A. Yes. Again, however, there is an alternative view of the alleged infirmities in the Hatfield approach. From the DOD/FEA's perspective, Verizon is exaggerating its costs. Verizon's inflated costs have a major impact on its proposed rates. Rebuttal

<sup>&</sup>lt;sup>2</sup> *Id.*, p. 30.

- 1 testimony by a witness for several potential competitors, called the CLEC Coalition,
- 2 explains the adverse effects.<sup>3</sup>
- 3 Q. What does the witness say?
- 4 A. Witness August H. Ankum states that the competitive LEC industry is not
- 5 nearly in the shape that Verizon claims.<sup>4</sup> He explains that the industry can no longer afford
- 6 approaches that lead to inflated rates.<sup>5</sup> Basically, his concern appears to be the same as I
- 7 expressed in my own testimony if the Department does not ensure that Verizon's
- 8 charges for UNEs are reasonable, there will be few competitive alternatives available to
- 9 the government or any other end users of telecommunications services.<sup>6</sup>
  - Q. Turning to Verizon witness Vander Weide, what conclusions in his rebuttal
- 11 testimony do you address?
- 12 A. I disagree with witness Vander Weide's claim that a "target market value
- 13 capital structure" containing 25 percent debt and 75 percent equity should be used as the
- basis for the company's assumed weighted average cost of capital in setting charges for
- 15 UNEs in this case.<sup>7</sup>

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- 16 Q. Does witness Vander Weide rely solely on market value weights?
- 17 A. Yes. He asserts that financial and economic theory requires the use of
- market value weights to calculate the weighted average cost of capital because market
- values are the best measures of the amounts of debt and equity investors have invested in
- 20 the company on a going-forward basis.8
  - Q. Do you agree?

6 Rebuttal Testimony of Harry Gildea, p. 4.

8 Rebuttal Testimony of James H. Vander Weide, p. 34 (emphasis supplied.)

The CLEC Coalition includes Allegiance Telecom, Covad Communications, El Paso Networks and Network Plus.

<sup>&</sup>lt;sup>4</sup> Rebuttal Testimony of August H. Ankum, p. 12.

<sup>&</sup>lt;sup>5</sup> *Id.* 

Direct Testimony of James H. Vander Weide, p. 48.

- A. No. Verizon could take steps to transition its capital structure to a mix of 25 percent debt and 75 percent equity in the future. However, as I explained in my Rebuttal Testimony, for a company of this size, significant shifts in the capital structure take a long while to accomplish.<sup>9</sup> To shift its capital structure this much, Verizon would have to retire many billions of dollars of debt and/or issue many billions of dollars of equity capital.
- Q. Do individuals and institutions investing in Verizon focus on the company's activities in providing UNEs in Massachusetts?
- A. No. Of necessity, the individuals and institutions must assess the total company as a diverse enterprise providing wireline and wireline telecommunications services, and information services, with operations scattered widely throughout the U.S. and other countries. In this proceeding, we are concerned <u>only</u> with the wholesale leasing of UNEs to competing local exchange companies in Massachusetts.
- Q. What is the significance of this fact?
- A. In his rebuttal testimony on behalf of AT&T/WorldCom, John I. Hirshleifer explains that it is important to address the cost of capital "for the business in question." Witness Hirshleifer states that the narrowly defined "business in question" in this proceeding is a distinctly different and far less risky business than the overall combined businesses of the publicly–traded holding company. In agree with this observation. Therefore, even if a debt ratio of 25 percent were appropriate in assessing Verizon's overall operations, a much higher debt ratio should be used in establishing the costs of UNEs in this case.
  - Q. Have regulators in nearby states recently considered this issue?
- A. Yes. To determine UNE costs in an order adopted February 4, 2000, the Vermont Public Service Board prescribed a capital structure reflecting the midpoint

<sup>9</sup> Rebuttal Testimony of Harry Gildea, p. 9.

Rebuttal Testimony of John I. Hirshleifer, p. 27.

*Id.*, pp. 27–28.

between market value and book value weights.<sup>12</sup> The result is a capital structure of 36 percent debt and 64 percent equity.<sup>13</sup> Also, on May 16, 2001, the Administrative Law Judge presiding over the UNE case in New York issued a Recommended Decision adopting a capital structure of 35 percent debt and 65 percent equity.<sup>14</sup> The findings in Vermont and New York fall a little short of the 40 percent debt ratio that I urge the Department to adopt, but they are closer to my recommendation than to the 25 debt ratio advocated by Verizon witness Vander Weide in this case.

Q. On page 34 of his rebuttal testimony, witness Vander Weide asserts that economists "unanimously" reject the use of book value capital structures. Do you agree?

A. No. This statement implies that the use of market value weights is a well-settled matter, at least for ratemaking purposes. That is not correct. Authorities accord more respect to book value weights than witness Vander Weide acknowledges. For example, a reference that tabulates financial ratios contains a discussion of capital structure. This reference states that the phrase capital structure has "different meanings to various people." However, in the "broadest" sense, capital may include "preferred stock, either at par value or at market value, common stock at par value, paid—in capital, retained earnings (earnings surplus), long—term debt, and short—term debt." Each of these elements appear in the company's books — specifically on the company's balance sheets.

Q. Can you cite additional authority for consideration of book value weights?

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Vermont Public Service Board Docket No. 5713, Order entered February 4, 2000, p. 41.

<sup>13</sup> Id

New York Public Service Commission Case No. 98–C–1357, Recommended Decision, May 16, 2001, p. 79.

Prentice Hall, 1991, "The Vest–Pocket Guide to Business Ratios."

<sup>&</sup>lt;sup>16</sup> *Id.*, p. 56.

<sup>&</sup>lt;sup>17</sup> *Id.* 

A. Yes. The reference is "Utilities' Cost of Capital" by Roger A. Morin,
Professor of Finance at Georgia State University. That book contains a discussion of
many issues concerning capital costs. It states:

In the context of rate making for regulated utilities, it is universal practice to employ a hybrid computation consisting of embedded costs of debt and a market–based cost of equity with costs of debt and equity both weighted at their respective book values in the determination of the weighted average cost of capital.<sup>19</sup>

The text goes on the explain that the use of book value weights is defended on several grounds.<sup>20</sup> First, the relationship between debt and equity at book value is an expression of the company's long-term capital structure policy.<sup>21</sup> Second, book value proportions are more stable.<sup>22</sup> Third, if regulation performs adequately, book value and market value of equity will be driven towards equality.<sup>23</sup>

Q. What is your assessment of these conclusions?

A. The reference supports use of book values for ratemaking purposes, which does <u>not</u> indicate unanimous rejection of the approach, as Verizon witness Vander Weide claims.

Q. In your Rebuttal Testimony, you stated that an additional factor leading to excessive costs for UNEs is that Verizon is not showing savings to be expected from the recent merger with GTE. Does another witness also address this matter in rebuttal testimony?

A. Yes. The rebuttal Testimony by Michael R. Baranowski on behalf of AT&T/WorldCom explains that UNE charges should consider forward–looking cost savings

Public Utilities Reports, Inc., 1984, "Utilities Cost of Capital."

*Id.*, p. 265 (emphasis supplied.)

*Id.*, p. 266.

*Id*.

<sup>&</sup>lt;sup>22</sup> Id.

<sup>&</sup>lt;sup>23</sup> *Id.* 

1 from efficiencies produced by Verizon's recent mergers.<sup>24</sup> Witness Baranowski's

2 testimony goes on the describe the method employed to estimate the savings in New

3 York.<sup>25</sup> While that approach is reasonable, I believe it is preferable for the Department to

require Verizon to provide a specific estimate of savings, with detailed support, for review

5 by the staff and other parties in this case.

Q. In your Rebuttal Testimony, you mentioned some recurring expenses that

Verizon does not incur when providing UNEs to other carriers. Do other witnesses

address this issue?

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9 A, Yes. Witness Baranowski explains that all of Verizon's advertising costs

should be considered "avoided" in determining the charges for UNEs.<sup>26</sup> Also, CLEC

Coalition witness Warren R. Fisher has the same recommendation, noting that Verizon

does not need to advertise to competitive carriers in order to find "buyers" for its unbundled

elements.<sup>27</sup> I concur with these witnesses on this issue. In fact, as I explained in my

Rebuttal Testimony, Verizon's failure to exclude all advertising costs is one of the primary

infirmities in its "avoided cost" presentation.<sup>28</sup>

Q. In your Rebuttal Testimony, you addressed the network element called House

and Riser cable. Do you have additional comments concerning these facilities based on

the rebuttal testimony filed by other parties?

19 A. Yes. Moreover, the testimony indicates that competitive LECs may have

difficulty in obtaining access to House and Riser cable on an equal basis to Verizon. This

is an important issue to DOD/FEA.

Q. Why?

Rebuttal Testimony of Michael R. Baranowski, p. 41.

<sup>&</sup>lt;sup>25</sup> *Id.*, p. 42.

<sup>&</sup>lt;sup>26</sup> *Id.*, p. 44.

<sup>27</sup> Rebuttal Testimony of Warren R. Fisher, p. 34.

Rebuttal Testimony of Harry Gildea, pp. 14–17.

- A. The Federal Technology Service of the U.S. General Services Administration ("GSA") has been conducting a nationwide Metropolitan Area Acquisition ("MAA") program to implement advanced telecommunications services in major metropolitan areas. Incumbent and competitive LECs bid against each other for contracts to provide telecommunications services to federal agencies in each area. In some metropolitan areas, including Boston, contracts have been awarded to several vendors. Therefore, it is important that all carriers incumbent and competitive LECs have equal access to the cable in buildings where federal offices and located.
  - Q. Why do you believe equal access may be a problem?
- A. In his rebuttal testimony on behalf of AT&T/WorldCom, John C. Donovan explains the Verizon's proposals for connections to House and Riser cable reflect "a confusing, complex, inefficient design" that gives a distinct advantage to Verizon over its competitors.<sup>29</sup> For example, competitors' configurations involve more cross—connections, making them less reliable and more troublesome from a maintenance standpoint.<sup>30</sup> Moreover, Verizon's proposed configurations lead to more equipment and greater UNE costs, which places other carriers at a significant competitive disadvantage.<sup>31</sup>
- Q. Do other competitive LECs also indicate infirmities in Verizon's costs for House and Riser cable?
- A. Yes. CLEC Coalition witness Ankum states that Verizon's "costs" for House and Riser cable reflect an unrealistic utilization factor.<sup>32</sup> He explains that the fill for House and Riser should be higher than that for the distribution portion of the local loop, a point I made in my Rebuttal Testimony.<sup>33</sup>

<sup>&</sup>lt;sup>29</sup> Rebuttal Testimony of John C. Donovan, pp. 32–33.

<sup>&</sup>lt;sup>30</sup> *Id.*, pp. 32–35.

*Id.*, pp. 35–36.

Rebuttal Testimony of August H. Ankum, p. 12.

*Id.*, and Rebuttal Testimony of Harry Gildea, pp. 18–19.

- 1 Q. What is your recommendation?
- A. I urge the Department to reject proposals by Verizon that require interconnections by competitors to be more complex or costly than necessary. Also, I urge the Department to examine Verizon's claimed costs for House and Riser cable very closely to be sure that the company is not inflating UNE prices though inefficient designs, or inappropriate cost input parameters such as utilization factors and work times that I
- 8 Q. Does that conclude your testimony?

discussed in my previous testimony in this case.<sup>34</sup>

9 A. Yes, it does.

Rebuttal Testimony of Harry Gildea, pp. 18–19.